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SUBJECT: DESIGNING A SYSTEM CREATING A BANKRUPTCY
MECHANISM FOR FINANCIAL INSTITUTIONS

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¶1. Reftel reported on Embassy discussions with Professor Li Shuguang on September 6 about China's new Law on Enterprise Bankruptcy. As Director of the Bankruptcy Law and Restructuring Research Center at the China University of Politics and Law, as well as a member of the National People's Congress drafting group which prepared the new law, Li is a leading expert on China's bankruptcy regime. During the September 6 meeting, Li told Emboff that China would need new regulations to apply the new law to financial institutions. On September 18, Li published an article in "Caijing" (Finance) Magazine laying out nine areas where he believes regulatory clarification is necessary. An unofficial Embassy translation of the article appears below. The original Chinese text is available at
http://caijing.hexun.com/text.aspx?sl=2324&id =1832111.

¶2. Begin unofficial Embassy translation of text of Professor Li?s 18 September Caijing article:

Designing a Bankruptcy System for Financial Institutions
by Li Shuguang

On August 27 of this year, the new "PRC Law on Enterprise Bankruptcy" was passed by the National People's Congress, and it will go into effect on June 1, 2007.

Article 134 in the supplementary provisions of this law sets forth special regulations specifically for the problem of bankruptcy of financial institutions. In the nine months between the new "Bankruptcy Law's" passage and when it goes into effect, the new law gives the Central Government power to establish procedures for financial institution bankruptcies. In my view, any "implementation measures (or regulations) on carrying out financial institution bankruptcy proceedings" should emphasize resolving the nine major problems listed below.

¶1. The definition and scope of "financial

institution."

At present, there is no law that provides a precise definition for "financial institution." Generally, institutions overseen by the three main supervisory bodies, the China Bank Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC) are regarded as financial institutions. Strictly speaking, this is not an accurate definition.

Such a definition overlooks other, more important supervisory bodies -- the Central Bank and the State Administration for Foreign Exchange (SAFE). The term "financial institution" should cover institutions subject to the supervision of these agencies.

Some types of businesses supervised by financial supervisory agencies are not considered financial sector businesses. For example, the futures industry, regulated by the CSRC, is considered part of the food and beverage industry. However, the new draft "Law on the Management of Futures Trading" has, in practice, already classified futures trading as a financial sector industry. So "financial institutions" already includes the futures and derivatives trading industry.

Some institutions with financial assets supervised by government finance agencies, such as financial groups like CITIC Group and China Everbright Group, etc., or financial asset management companies such as Huarong Asset Management Co. and Cinda Asset Management Co., should be included in the category "financial

institutions."

In addition, financial organizations sponsored by the Ministry of Agriculture, such as rural financial markets and agricultural credit cooperatives, should also fall within the definition of "financial institution."

¶2. Who files for financial institution bankruptcy?

Article 134 of the new Bankruptcy Law provides that "when financial institutions, such as commercial banks, securities firms, or insurance companies, are in the situation described in Article 2 of this law, State Council financial supervisory agencies may apply to the People's Court to reorganize or liquidate the financial institution in question." This raises the question of whether the financial institutions themselves can file for bankruptcy, and whether creditors can file for bankruptcy proceedings against them.

Two considerations went into drafting this article. The first consideration was that non-state-owned financial institution bankruptcy cases need not necessarily go through the State Council. The second was that in the current "Commercial Bank Law," "Insurance Law," and "Securities Law," bankruptcies of commercial banks, insurance companies and securities firms must receive authorization from the State Council as a prerequisite, companies which are not commercial banks, insurance companies or securities firms do not necessarily need to.

The regulations do not prescribe financial institutions from voluntarily filing for bankruptcy. Implementation measures (or regulations) should be drafted so as to clarify which types of financial institutions must report to or receive approval from the State Council in filing for bankruptcy, and which do not.

3) Prerequisites for Financial Institution Bankruptcy Filings.

The "implementing measures (or regulations)" can continue existing rules on prerequisites for financial institution bankruptcies, and at the same time expand their scope to include bankruptcy filings for futures trading companies, large trust companies, and large financial holding companies, requiring that the State Council approve their filings as well. Bankruptcy proceedings for other small- and medium-sized financial institutions can be treated in the same way as corporate bankruptcies.

4) Administrating Bankruptcy Proceedings for Financial Institutions.

Because of the special nature of bankruptcies of financial institutions, commercial administrating bodies or administrators do not necessarily have any special qualifications for taking control of the assets of bankrupt financial institutions or administering their affairs through bankruptcy proceedings. They also lack experience in managing financial risks or financial crises. A system should be considered in which liquidation groups, or administrating bodies are set up jointly by financial regulators in cooperation with commercial specialists, and in which individuals given responsibility for administering bankruptcies would be drawn from the ranks of experienced financial specialists. So, "implementation measures" should specifically set forth the qualifications, method of selection, professional responsibilities and supervisory conditions for administrators of financial institution bankruptcy cases.

5) Reporting of Claims against Bankrupt Financial Institutions.

Because China is in a particular phase of economic transition, commercial credit transactions tend to be relatively chaotic, and in the disorderly use of legal concepts, property rights, shareholders' rights, creditors' rights and renters' rights tend to get tangled together. It is not clear what really can be considered debt. For example, when a commercial bank goes bankrupt, is there a debtor-creditor relationship between the bank and its account holders? If a securities firm misappropriates its customers' down-payments, is the customer whose funds were used in such a manner a simple creditor or a secured creditor? In terms of fundamental principles, these questions are debatable and it is sometimes hard to make clear distinctions.

As another example, after the Central Bank, the CSRC and other agencies jointly issued the "Notice regarding the questions related to individual claims and customers' security trading settlement funds of securities companies," quite a few investors have different ideas. There is no question that individual bank deposits, all types of financial bonds issued by financial institutions and held by residents, and settlement funds from customers' securities trades fall within the category of debt instruments. As for property entrusted by residents to financial institutions for trading, and residents' negotiable securities deposited in relevant accounts, but misappropriated by financial institutions, different opinions exist about whether they should be considered as individual claims.

In line with the development of China's financial markets and economy, new kinds of financial bonds will continually emerge. I recommend that any "implementation measures" clearly delineate personal and institutional debts, but also give judicial institutions room to make precedent-setting rulings regarding the delineation of various types of financial bonds.

¶6. Reorganizing Bankrupt Financial Institutions.

Because the social repercussions of the bankruptcy of financial institutions are relatively great, all countries encourage financial institutions to choose the option of reorganization when they go bankrupt, unless there is no other possible choice. This process generally involves the government injecting capital, taking over the institution, placing it in the care of a trustee, refinancing through the Central Bank, or some similar method. Of course, reorganization can also be left to the market.

I recommend that any "implementation measures (or regulations" require that: 1) During the period of reorganization, the debtor must not manage its own assets, but rather should be taken over by the government, placed under the care of a trustee, or assigned to a specially designated administrator, in order that the government can guide the reorganization process. 2) The period of time to prepare a reorganization plan for a financial institution should be longer than for other enterprises. I recommend 360 days. 3) Financial institutions' creditors should be divided into different kinds of categories than in ordinary bankruptcy cases. In general, individual creditor?s rights should be separated from financial claims. The particular characteristics of creditors and shareholders, such as depositors, holders of securities, holders of futures, and holders of insurance policies should be given consideration, and at the same time, the problem of protecting the rights

of claims of employees of financial institutions should be given appropriate consideration. The implementation and supervision of the reorganization plan should receive close attention after its passage.

7) Monetization of Assets of Financial Institutions.

In financial institution bankruptcy cases, there are essentially two types of assets -- tangible and intangible -- which need to be monetized. The intangible assets of financial institutions mainly include their operating license trading rights, as well as their so-called "license plate" (their brand name), their marketing network and marketing operation. These are a financial institution's main assets, and their value is considerable.

In order to better carry out the monetization of the assets of financial institutions, any "implementation measures" should set forth that: 1) The value of intangible assets must be assessed, not just tangible assets. 2) The monetization of a financial institution's assets, the disposition of its operating license, its brand name, and the settlement of the entitlements of its employees should be considered all together, and listed in the conversion plan of insolvent assets. 3) The assets of a financial institution should be monetized openly, through the mechanism of an auction based on the principle of competition.

8) The Special Nature of Allocation of Assets in Financial Institution Bankruptcy Cases.

In financial institution bankruptcy cases, Western countries have established a principle of "limited repayment," also known as "creditor's discount." This means that when a financial institution goes bankrupt, a limit is set on individual claims, below which the creditor is repaid in full, but above which the creditor only receives a set proportion of their claim. In setting a ceiling, one must consider such factors as this country's phase of economic development, the investment capacity of investors, and society's ability to bear the burden. In the past two years, in dealing with the troubled securities firms Dapeng Securities and China Southern Securities?and the D?Long Group crisis, the People's Bank of China and others used rules and methods based on purchasing individual?s claims at a discount, in an effort to appropriately solve the problem of the who gets priority in repayment among individual creditors, and treated all non-secured institutional creditors as regular creditors. This type of principle can be rolled into any "implementing measures (or regulations)."

9) Guaranty Funds for Investors in Financial Institutions.

According to the existing regulatory framework, three major types of guaranty funds should be prepared for the bankruptcy of financial institutions: a depositor's insurance fund, an insurance holder's guarantee fund, and a security investor's guaranty fund. I believe that the first two will be set up and designed in the same way as the already existing protection fund for securities investors. But the problem is that these three funds do not provide protection for all bankrupt financial institutions. As a result, in preparing "implementation measures" it is worth considering whether the three funds should be combined into a single Financial Institution Investors Guaranty Fund, or as separate guaranty funds.

I believe, since each fund collects contributions in a different way, and from different sources, the principles and purpose of payment may vary, the

establishment of such funds should be handled in a flexible way. We could create three large funds, or establish different funds for futures investors and other types of investors, and set clear regulations on the source of funding, coverage, function, supervision, etc., and gradually increase the overall scale and reserve ratio of each fund over time.

END UNOFFICIAL EMBASSY TRANSLATION TEXT.

RANDT